odi ESAU Briefing Paper 3

Why Bangladesh has outperformed Kenya

Economics and Statistics Analysis Unit (ESAU)

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- Public works as a solution to unemployment in South Africa? Two different models of public works programme compared
- Why Bangladesh has outperformed Kenya
- What can the fiscal impact of aid tell us about aid effectiveness?

Overseas Develoment Institute
111 Westminster Bridge Road
London SE1 7JD
UK

Tel: +44 (0)20 7922 0300
Fax: +44 (0)20 7922 0399
www.odi.org.uk/esau

Overview

What can we learn from the divergent experiences over a forty-year period of two countries – Bangladesh and Kenya? This paper is a comparative growth narrative on the two countries.[1] The explanations of performance differences have resonance and relevance for other countries.

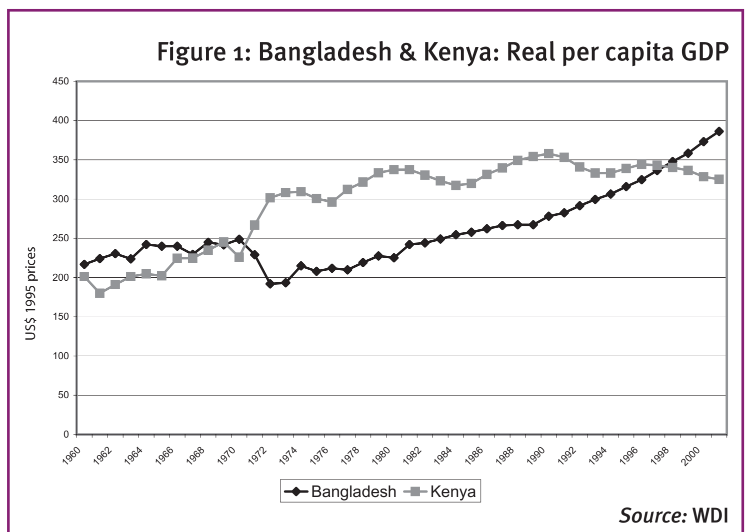
Development outcomes compared

The two countries started with similar characteristics as regards per capita income and stock of physical and human capital. They have suffered similar terms-of-trade shocks, and have acquired similar reputations on governance and corruption. Yet, in the 1990s and early 2000s, per capita income was falling in Kenya but rising steadily in Bangladesh.

Kenya's growth trend between 1960 and 2001 was higher than Bangladesh's (respectively 4.8% p.a. and 3.6% p.a.), but its population growth rate (3.3%) was also distinctly higher than Bangladesh's (2.4%), leading to similar period average per capita income trend growth rates (respectively 1.5% p.a. and 1.2% p.a.).

Big differences emerge when looking at sub-periods. In 1960, the two countries had a per capita GDP close to $200 in 1995 prices. Kenya grew fast in all sectors between 1960 and 1980 (Table 1). Kenya's average growth over the two decades was 5.8% p.a., while Bangladesh's was only 2.1% p.a. Therefore, in much of the 1970s and 1980s, per capita income in Kenya was $150-200 higher than in Bangladesh. But, between 1980 and 2001, Kenya only grew way below trend at 3% p.a., when Bangladesh was growing at 4.4% p.a. So, by 2001, Kenya was 16% ($60 per capita) poorer using GDP as conventionally measured (Figure 1), and 70% poorer using GNI at international prices.[2]

Figure 1: Bangladesh & Kenya: Real per capita GDP



Source: WDI

Kenya also lost its early lead in human development indicators (Table 2). Its life expectancy barely rose over the forty years to 2000, and its significant progress in reducing child mortality and increasing primary enrolments was reversed in the 1990s, partly due to the impact of AIDS. Bangladesh, on the other hand, achieved solid, steady and lasting improvements in all respects.

Why, then, did Kenya perform so well in the 1960s and 1970s, but then encounter difficulty, and how did Bangladesh manage to emerge from the doldrums into a period of sustained and solid growth, with steadily improving welfare indicators?

Main conclusion and implications

The country stories offer complementary object lessons, with Bangladesh showing how to recover with perseverance, and Kenya showing how persistently defective policies and governance may lead to loss of momentum and economic decline. Together they confirm contemporary received wisdom about the causes of, and conditions for, economic growth:

- Causality is complex, involving at least: (i) commitment to macroeconomic stability, based on maintaining internal and external imbalances within safely financeable limits, (ii) (fairly) efficient, competitive and soundly governed markets, with predictable regulations, protection for property rights, enforcement of contracts and low barriers to entry, (iii) financial incentives for producers to expand output by means

of (efficient) private investment, and to sell exports, and (iv) domestic savings sufficient to finance a major share of the investment undertaken by indigenous entrepreneurs, leading to (v) a confidence-inspiring environment for enterprise.

- Priority among these requisites is sui generis with respect to time and place; growth-oriented policies, functional institutions and probity in governance contribute powerfully to growth, but even major imperfections in aspects of these need not prevent growth, at least for a time.
- Investor confidence often reacts with long lags to changes in the policy/institutional environment, especially when the direction and pace of change is obscure.

The Bangladesh and Kenya stories add three other elements to the general conclusion:

- Perceptions about the direction of change of policies and governance are important. In Bangladesh there was a growing belief, at least among indigenous entrepreneurs, that policies were becoming more credible and that the environment was slowly improving. Savings and investment picked up. In Kenya, the reverse occurred: disillusionment grew, and savings and investment declined.
- Windfall terms-of-trade gains should be saved, and should not be used to increase public expenditure to unsustainable levels.
- High public expenditure is a double-edged sword: it may buy better, poverty-reducing, public services, but it may also be an invitation to misallocation and waste on a larger scale; and high revenue mobilisation exacts a deadweight cost.

Bangladesh's story

In 1947, what was later to be Bangladesh became the East Wing of Pakistan. Its largely smallholder agricultural economy, in which the largest crops were rice and jute, lost its former links to industrial and consumer markets in West Bengal. The East Wing achieved modest per capita income growth, but it was handicapped by explicit and implicit taxation to the benefit of the West Wing. Its economic union with the West Wing increased the price of its imports, and worsened its terms of trade.

The independence war of 1971, and the ensuing political turmoil and violence, brought two years of acute economic instability, with the collapse of output and domestic revenue, and hyperinflation. Recovery occurred in the mid-to-late-1970s, with restored political stability and substantial external assistance. However, the now nationalised industrial, commercial and infrastructural assets belonging to departed non-Bengalis were ill-managed, and the economy experienced many years of supply-side bottlenecks.

Economic growth nevertheless gathered momentum in the 1980s and 1990s. Total factor productivity, previously negative, turned (just) positive. Econometric evidence identifies investment in physical and human capital and export growth as the most significant causes of growth.

The following six linked pro-growth policy actions stand out in the historical record:

- *Stabilising the macroeconomy*. After serious instability in the mid-1970s, with GDP inflation above 70% in some years, the government successfully calmed inflation and inflationary expectations. In the 1980s, it kept rises in the GDP deflator down to an average of 15% p.a., and in the 1990s to below 10% p.a. There was very little borrowing by the government until the later 1990s. This helped to keep interest rates stable, and fairly low, which reinforced business confidence in the conduct of affairs.

- *Maintaining fiscal control*. Both domestic revenue and public expenditure have been low in Bangladesh by the standards of low-income countries. Public expenditure was kept below 10% of GDP in the 1980s, though it rose to 12-14% in the early 1990s. Revenues, as low as 5% of GDP in the early 1970s, have since remained below 10% of GDP. Budget management has been traditional and unsophisticated, but firm enough to prevent unplanned, runaway, destabilising, expenditures.

- *Strengthening the balance of payments*. Though external markets for Bangladesh's main export products, jute and jute textiles, were shrinking steadily, exports grew from a low of below 5% of GDP in the turmoil of the 1970s, at first slowly to below 10% of GDP in the 1980s, and then strongly to nearly 15% over the 1990s, on the basis of rapidly rising sales of ready-made garments.

The resource gap (exports minus imports and, equivalently, savings minus investment) shrank in the 1980s, as income and exports grew and domestic absorption was restrained. The balance of payments was further strengthened by rising remittance receipts amounting to 2-4% of GDP (Figure 3), and concessional external assistance amounting to 5-7% of GDP (Figure 4).

Serious external payments crises were avoided, despite a sharp fall in the terms of trade between 1976 and 1983, facilitating the extensive liberalisation of trade and payments on current account, implemented mainly in the early 1990s. Bangladesh inherited no debt burden on

Table 1: Bangladesh and Kenya: Average GDP growth by sector, by decade

	Agriculture		Industry		Services		GDP	
	B'desh	Kenya	B'desh	Kenya	B'desh	Kenya	B'desh	Kenya
1960-70[1]	2.68	4.58	7.37	6.27	3.41	6.38	3.63	4.24
1970-80	0.59	4.65	5.08	8.28	3.21	6.15	2.52	6.00
1980-90	2.64	3.28	3.87	3.87	4.31	4.78	4.26	4.12
1990-2001	3.05	1.23	6.95	1.60	4.46	3.06	4.76	2.26

Note: 1. For Kenya 1964-70

Table 2: Bangladesh and Kenya health and education indicators

	1970		1980		1990		2000	
	B'desh	Kenya	B'desh	Kenya	B'desh	Kenya	B'desh	Kenya
Life Expectancy	44	50	45	56	55	57	61	47
Child Mortality[1]	239	156	205	115	144	97	77	122
Primary Enrolment[2]	54	62	61	115	72	93	100	94

Notes: 1. Under-5 mortality per 1000 live births; 2. Gross primary school enrolment as % of the primary school age group
Source: World Development Indicators, World Bank

independence, and made virtually no subsequent use of non-concessional borrowing, long-term or short-term. It has thus avoided debt crises.

In the 1990s, earnings from remittances and exports reduced the current account deficit, and there were lower inflows of aid (Figure 4). Bangladesh continued to use concessional resources from the IMF, but more for assurance than out of dire necessity.

• *Implementing slow but steady structural adjustment reforms*. As well as liberalising external trade and payments, Bangladesh removed many controls on domestic prices and investment, and abolished state monopoly in financial services and agricultural input supply and marketing. Foreign investment, of which there was virtually none in the 1970s and 1980s, was, in the 1990s, welcomed into telecommunications, and into industries using Bangladesh's abundant but under-utilised supplies of natural gas. However, privatisation of state enterprises in transport, power (where tariffs still do not cover costs) and jute textiles has been resisted. These enterprises account for the banks' large portfolio of non-performing loans, which increases the cost of borrowing for profitable borrowers.

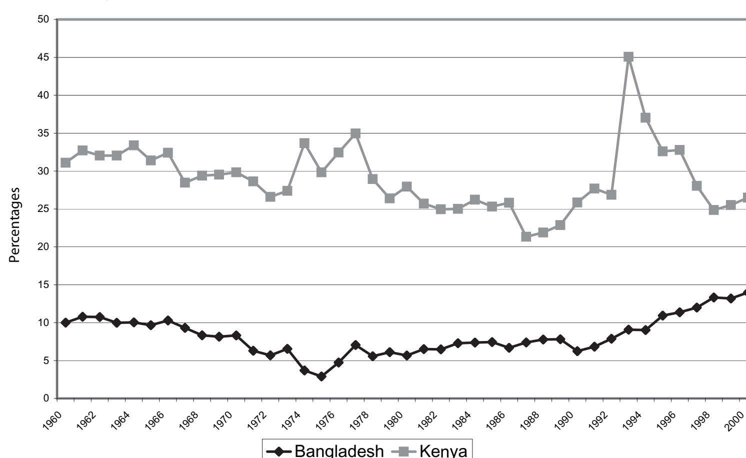
Though Bangladesh's reforms have been tardy and incomplete, they have not been reversed. The policies that they embody have therefore been understood and trusted as bases for business decisions.

• *Achieving productivity growth in agriculture*. Since 1970, Bangladesh has doubled its production of rice, its staple cereal, which it now no longer needs to import. This has been achieved through many years of endeavour in introducing Green Revolution (improved seed and fertiliser) technology, and increasing the gross cropped area by shallow tubewell irrigation. The ratio of land cultivated in the course of a year to land area (cropping intensity) increased from 150% in the 1960s to 190% by the end of the 1990s, because of the spread of irrigated farming in the dry (Boro) season. Investment in shallow tubewells was assisted by external donors. The government's agricultural research and extension agencies helped farmers to adopt new technology, and policy measures to liberalise input supply and marketing, and to allow producer prices to rise, encouraged them to do so.

Agriculture's share of Bangladesh's GDP fell substantially, despite these advances, from 50% in 1960 to a little over 20% in 2000. Nearly half the fall was due to falling relative prices, and the remainder to slower growth in agriculture relative to other sectors. Nevertheless, as the population of Bangladesh remains mainly rural, agricultural growth, which accelerated in the 1990s, has made a notable contribution to poverty reduction.

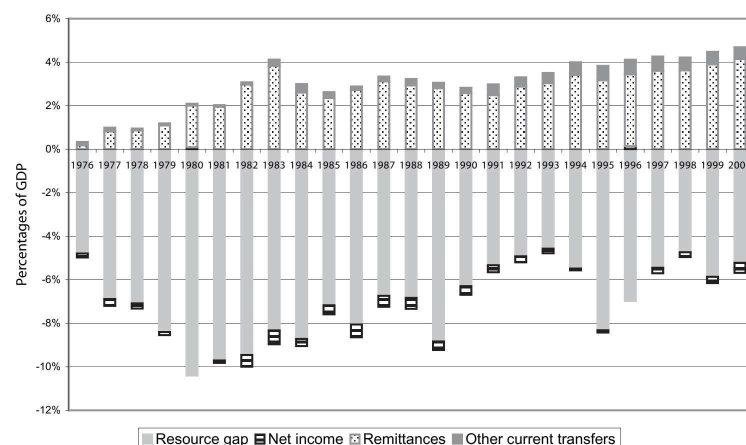
• *Creating a better business environment*. The business environment is far from ideal in Bangladesh. Investment Climate Surveys emphasise the negative impact of pervasive corruption and of unreliable power supplies (World Bank, 2003). Unnecessary costs arise from bureaucratic obstruction, delay in starting businesses and difficulties in enforcing contracts. However, despite these problems,

Figure 2: Bangladesh & Kenya: Exports as a share of GDP (current prices)



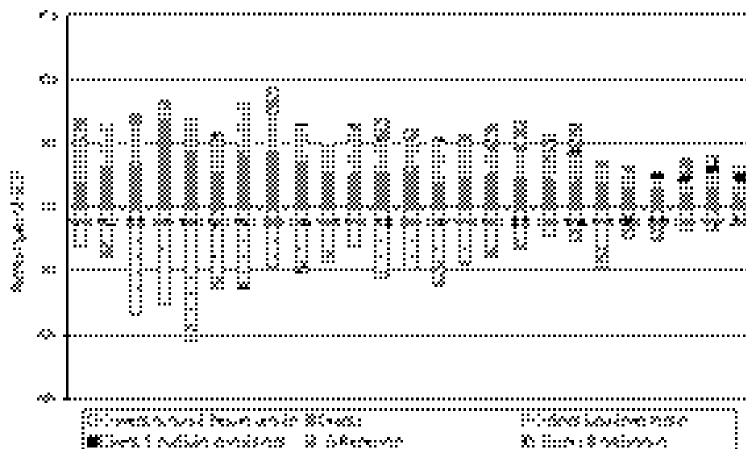
Source: World Development Indicators, World Bank

Figure 3: Bangladesh: Resource gap and current financing



Source: Balance of Payment Statistics, IMF

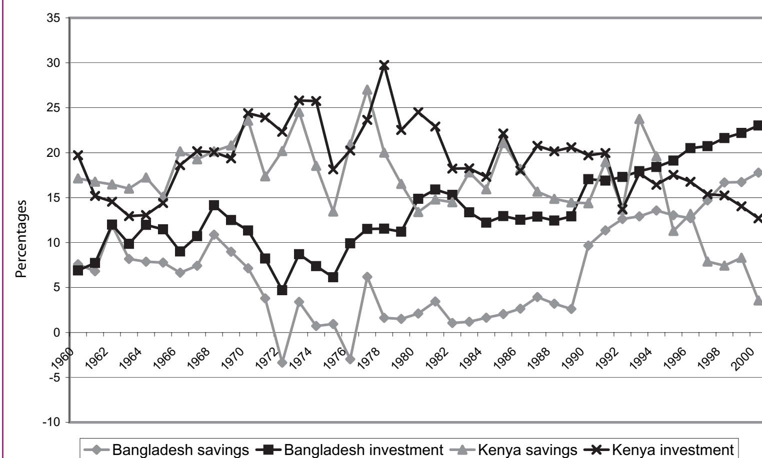
Figure 4: Bangladesh: Current account deficit and official financing



Source: Balance of Payment Statistics, IMF

Bangladesh has seen a flourishing of domestically-financed, labour-intensive, indigenous enterprise, most spectacularly in the export-oriented garment industry. Few small-to-medium enterprises pay direct tax. Factor markets worked well enough to funnel capital, business skills and Bangladesh's abundant supply of semi-skilled labour into activities in which the country has comparative advantage: by 2000, 80% of exports consisted of textiles and clothing. They were competitive enough to restrain costs and maintain international competitiveness. Barriers to entry were low enough to permit a multiplication of new enterprises.

Figure 5: Bangladesh and Kenya: Savings and investment as shares of GDP, 1960-2000



Source: **World Development Indicators, World Bank**

The gross investment expenditure, which was less than 15% of GDP until 1990 – too low to sustain accelerated growth – rose over the 1990s to 23% of GDP, with the increase mostly financed by rising domestic savings (Figure 5). The remarkable rise in domestic savings, which were negligible for most of the 1970s and 1980s, but which rose from 10% to 17% of GDP over the 1990s, is principally due to strengthening private sector confidence in the country's economy; the government's savings rate was declining in the 1990s.

Kenya's story

Kenya's growth narrative has two parts: the successful years, up to the early 1980s, and the subsequent troubled years.

The successful years. Kenya started as an independent country in 1963 with major advantages – geographical, agro-climatic, logistical and commercial. It had a coastal location, close to well-frequented shipping routes. Its interior fertile highlands, which offered opportunities to expand both subsistence and commercial farming, were accessible by road and rail. High-yielding hybrid varieties of maize suitable for small-scale farming were appearing. Commercial, export-oriented, agriculture was expanding with inward and local investment in coffee, tea, dairy and horticulture. Kenya was, moreover, the commercial, financial and manufacturing hub of the East Africa Community (EAC) – it was well served by commercial services, and its producers enjoyed untrammelled access to the markets of the other members of the EAC.

Economic growth was sustained by:
• capacity created by rising investment, including significant inflows of foreign investment (Figure 5);
• rising receipts from exports (over 30% of GDP) and tourism, which doubled in real terms; and
• public expenditure (with government consumption rising from 10% to 20% of GDP).

The seeds of future difficulty were, however, being sown. With rising public expenditure came increases in government employment, and rising formal sector wage rates. Fiscal caution was abandoned in the mid-1970s when coffee prices rose; the country embarked on programmes of expenditure which it was unable to finance when, later in the decade, coffee prices collapsed. The resource surplus of the 1960s became a gaping resource deficit in the late 1970s and early 1980s, which was financed by external borrowing, much if it on non-concessional terms.

The troubled years. The deceleration of growth after 1980 affected all sectors, but was more marked in agriculture and industry than in services (Table 1).

It happened in spite of a growing educated labour force. A declining birth rate led to an increase in the population of working age relative to the total population, and educational progress in earlier years led to a continuing improvement in the quality of the labour force, measured by the years of schooling of the working-age population.

There is no simple explanation of why the improving skills of Kenya's growing labour force were prevented from achieving their productive potential. Econometric evidence for the last three decades shows that the proximate causes of GDP growth have been investment in physical and human capital and exports, and that growth has been retarded by macroeconomic instability, external debt, and adverse terms-of-trade shocks. Tanzania and Uganda were also affected by the same adverse exogenous factors – such as the sharp fall in coffee prices at the end of the 1990s, and the spread of HIV/AIDS – as Kenya, without similar loss of growth momentum. The most convincing underlying explanations are therefore to be found in Kenya's internal policies and institutions.

• *The momentum of investment and savings faltered*. Kenya's investment/GDP ratio was sustained in the 1980s, but fell from over 20% to below 15% in the 1990s (Figure 5). Private as well as public investment was affected, as investors' confidence waned. The share of foreign investment in total investment expenditure declined from over 3.5% in the 1970s to a little over 1.1% in the 1990s. Domestic savings also declined in the early 1980s, and again in the 1990s, dropping from a late-1970s peak of over 20% of GDP to only 5% in 2001, leaving a wide resource gap of 5-10% of GDP throughout the two decades, except in years of high coffee prices.

• *The momentum of export growth was broken*. The volume of exports, which grew at 3.5% p.a. on average up to 1980, increased thereafter at only 1% p.a. As a share of GDP, exports fell from 30% in the late 1970s to a little over 20% in the early 1990s (Figure 2), but rose thereafter with a terms-of-trade improvement. The decline in exports to

troubled neighbouring markets was one cause; Kenya lost preferential access to Tanzania and Uganda in 1977. More important, however, was the fall in coffee production and loss of world market share for coffee exports. Horticultural exports have grown in fits and starts, but insufficiently to restore momentum to export earnings. Manufactured exports have enjoyed occasional success, but labour and logistical costs are too high in Kenya for a major and sustained breakthrough.

Kenya shows how trade preferences among countries in the South may lead regionally dominant economies to develop sector specialisation which is incompatible with their comparative advantage vis-à-vis the rest of the world. Before the East African Community dissolved in 1977, a high proportion of Kenya's exports – over half – went to importers in Africa. These exports were diversified, and included a significant share of manufactured goods produced at unit labour costs which were not internationally competitive.

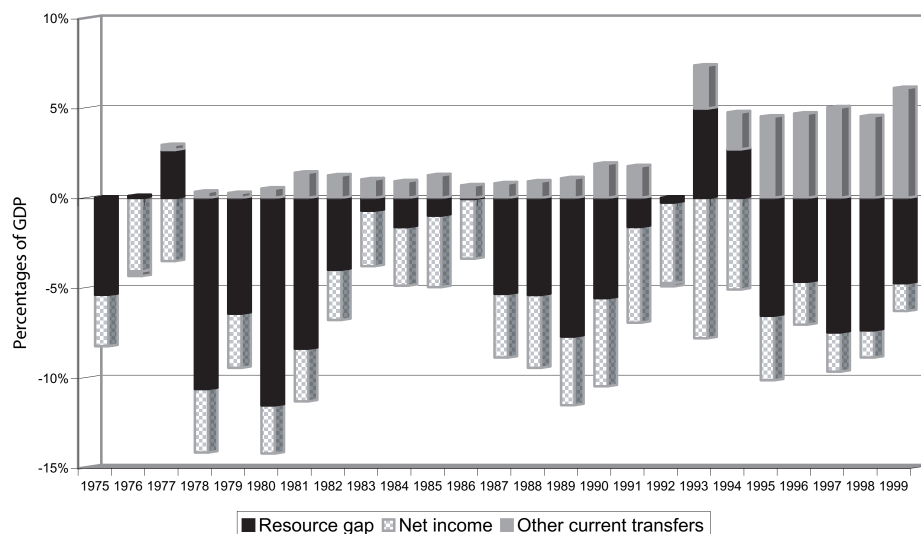
• *Macroeconomic management was erratic*. Until the mid-1990s, the government allowed public expenditure to rise when revenues were strong, but did not trim outlays when revenues weakened, for example in the 1980s, when revenues fell from 30% to below 25% of GDP because of falling coffee prices. The budget was in almost continuous deficit between 1970 and the mid-1990s, and deeply so in the late 1980s. Deficits were financed by domestic and external borrowing. Non-concessional foreign borrowing continued until the beginning of the 1990s, then declined with mounting arrears of debt-service payments. Domestic borrowing then increased, alternately funded by issuing treasury bills and monetisation. In the former case it led to high interest rates (which peaked at 50% in 1993), and in the latter to money supply expansion and inflation (which peaked at 35% in 1994).

The improvident conduct of macroeconomic policy was a major factor in inducing instability and unpredictability into the economy. It also interrupted the smooth inflow of external assistance. It lasted until the mid-1990s when, in the face of falling revenues and curtailed access to external financing and high inflation, the government asserted fiscal control, cut public expenditure and payrolls, and began to reduce public debt by running fiscal surpluses. This had the effect of reducing, and in some years eliminating, the balance-of-payments current account deficit. It did not, however, bring complete price stability, because inflationary expectations had induced a fall in the demand for money, which offset the otherwise stabilising effect of lower money supply growth.

The policy of austerity also accelerated the deterioration in the quality of public services, including power and transport infrastructure, raising users' costs and prolonging the private sector's distrust of public policy.

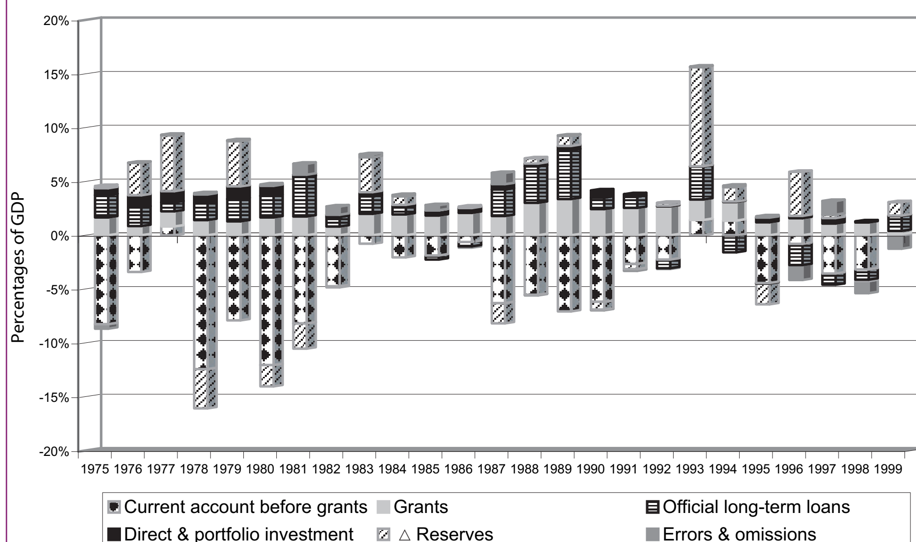
• *Balance-of-payments management was inept*. With poor export performance, punctuated by terms-of-trade fluctuations, Kenya's balance of payments was inherently difficult to manage. The situation was worsened by a resource gap generally in excess of 5% of GDP, by the mounting burden of servicing external debt contracted on non-concessional terms (Figure 6), and by deteriorating relations with the IMF and the donors of concessional assistance.

Figure 6: Kenya: Resource gap and current financing



Source: Balance of Payment Statistics, IMF

Figure 7: Kenya: Financing the current account deficit



Source: Balance of Payment Statistics, IMF

Aid inflows in the 1980s and 1990s were volatile and rarely exceeded 5% of GDP (Figure 7). There were years of high foreign exchange reserve loss, e.g. 1983, 1993 and 1996. The policy response in the 1980s was typically to delay payments and apply exchange restrictions. In the 1990s, when exchange policy was liberalised, the response was to tighten macroeconomic policy.

• *The public sector was too large, expensive and inefficient*. In the first two decades after independence in 1964, Kenya expanded its public service and parastatal sectors rapidly. Public sector employment was 40% of the formal wage-earning labour force in the mid-1970s, and 50% of it in the mid-1980s. The public sector's demand for labour raised real wage rates in the rest of the formal sector.

In the 1980s and early 1990s, Kenya's revenues and expenditures were high compared with other African countries – respectively 25-30% and 30-35% of GDP. Tax levels were therefore relatively high, and the scope for abuse in revenue administration and public expenditure management was correspondingly wide. Starting in the 1970s, appointments to management positions in public institutions, parastatals and even the judiciary were made as rewards for political services, rather than on merit. Senior politicians and administrators were also authorised to engage in private business, leading to conflicts of interest.

Management standards deteriorated as patrimonial practices proliferated. Voted public funds were diverted for personal or political gain, depriving public services of resources. The effectiveness and accountability of management in the financial services, agricultural marketing, power, transport, ports and telecommunications sectors accordingly declined. Financial institutions were weakened because lax supervision tolerated unsound lending practices. Some institutions collapsed, leaving depositors to be compensated from public funds.

• *The implementation of structural reforms undermined confidence*. Kenya's economic reforms in the 1980s and 1990s were ostensibly far-reaching. Economic controls, including controls on domestic prices, foreign exchange current account transactions and interest rates, were largely removed, the currency was floated, and import duties were greatly reduced. Parastatal monopoly in agricultural marketing was abolished. Some parastatal enterprises, including some financial institutions, were privatised, although the main ones in transport, communications and power supply remained in the public sector. Regulations affecting private investors were streamlined.

However, the reforms failed to inspire investors' confidence because of: (a) their inept, reluctant and delayed implementation, which sent out conflicting signals, (b) the real exchange-rate appreciation in the years following exchange liberalisation in the mid-1990s, and (c) the persistence of entrenched informal clientelistic practices in the business environment, which were inhibiting competition and investment.

Confidence in policy was further weakened by frequent IFI programme suspensions and cancellations, caused by doubts about Kenya's commitment to reform its policies and governance.

• *Corruption and the costs of doing business were excessive*. Corruption added materially to the cost of doing business for enterprises, and it reduced the effectiveness of Kenya's large public service. It was compounded and aggravated by patrimonial and predatory practices in the élite. Private sector enterprises were encouraged to recruit political appointees to executive positions. Cronyism flourished in the award of business licences and contracts; formal and informal barriers to entry were erected to protect monopoly profits. Competition in the domestic market was thus reduced, making non-traded infrastructural and logistical services, such as road haulage and port handling, inefficient and costly to users. Cronyism was also a cause of delays and policy reversals in the removal of non-tariff barriers to imports, as vested interests manoeuvred to preserve their rents.

Incentives for enterprise and investment, especially in traded goods and services, have also been impaired by:
i. high formal sector labour costs: in the 1980s, unit labour costs are estimated to have been up to five times higher than in Bangladesh at current exchange rates, though the differential diminished sharply in the 1990s;
ii. high taxation: in the mid-1990s, direct taxes raised 10% of GDP, much more than in Bangladesh (1–1.5% of GDP);
iii. high (nominal) interest rates: lending rates rose with liberalisation from 15% in the 1980s to 30–35% in the mid-1990s.

• *The momentum of agricultural growth was lost*. Agricultural value-added growth declined from 3.2% p.a. in the 1980s to only 1.3% p.a. in the 1990s (Table 1). The decline affected both maize for the domestic market and coffee for export. Only tea and horticulture for export performed well. The causes of the decline were both technical and institutional. There was no successor to the hybrid maize whose wide adoption had led to continuous yield increases in the 1970s and early 1980s. Marketing reforms in cereals, dairy and coffee were botched, undermining producer incentives and reducing marketed production.

References

Roberts, J. and Fagernäs, S. (2004) Why is Bangladesh Outperforming Kenya? A Comparative Study of Growth and its Causes since the 1960s, ESAU Working Paper No. 5, Overseas Development Institute, London.

World Bank (2003) Improving the Investment Climate in Bangladesh: An Investment Climate Assessment, World Bank/Bangladesh Enterprise Institute, Washington, DC.

Endnotes

1. Based on Roberts and Fagernäs, 2004.
2 The $1/day headcount poverty rates given in World Development Indicators (World Bank) are, respectively, Bangladesh 36% and Kenya 23%, indicating less poverty in Kenya. However, these data are inconsistent with evidence on the two countries' per capita incomes at international prices ($1770 and $1010 in 2002) and Gini coefficients (32 and 45).

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For more information contact:
John Roberts (j.roberts@odi.org.uk), Overseas Development Institute, 111 Westminster Bridge Road, London SE1 7JD, UK, Tel: +44 (0)20 7922 0300
or visit www.odi.org.uk/esau